No. 83-1096

In the Supreme Court of the United States

OCTOBER TERM, 1983

GOMEZ-HERMANOS, INC., APPELLANT

v.

SECRETARY OF THE TREASURY OF PUERTO RICO

ON APPEAL FROM THE SUPREME COURT OF PUERTO RICO

BRIEF FOR THE UNITED STATES AS AMICUS CURIAE

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QUESTION PRESENTED

The Puerto Rico Income Tax Act imposes a flat 29% tax on Puerto Rico sourced interest payments received by corporations doing no business in the Commonwealth. The Act further requires Puerto Rican payors of such interest to withhold the tax at the source and remit it to Puerto Rican taxing authorities. The question presented is whether the Supreme Court of Puerto Rico correctly upheld the constitutionality of this taxing scheme as applied.

TABLE OF CONTENTS

TABLE OF AUTHORITIES

Cases:

Cases—Continued: Page

Constitution, treaty and statutes:

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This brief is filed in response to the Court's order inviting the Solicitor General to express the views of the United States.

OPINIONS BELOW

The opinion of the Supreme Court of Puerto Rico (J.S. App. 1a-5a) is not yet officially reported in English. The opinion of the Superior Court of Puerto Rico (J.S. App. 9a-21a) is not officially reported in English.

JURISDICTION

The judgment of the Supreme Court of Puerto Rico was entered on June 10, 1983 (J.S. App. 6a). Appellant's motion for reconsideration was denied on October 6, 1983 (J.S. App. 8a). A notice of appeal

was filed in the Supreme Court of Puerto Rico on October 24, 1983 (J.S. App. 24a). The jurisdictional statement was filed on January 3, 1984. The jurisdiction of this Court is invoked under 28 U.S.C. 1258(2).

STATEMENT

1. Appellant Gomez-Hermanos, Inc., is a corporation organized under the laws of Puerto Rico. It does business in Puerto Rico and has its main office in San Juan, Puerto Rico. It is engaged in the importation, distribution, and sale of motor vehicles and parts, including (during the tax years at issue) motor vehicles manufactured by Toyota Motor Co., and sold by Toyota Motor Sales Co., both of which are organized and do business in Japan. J.S. App. 1a-2a, 11a.

Appellant's orders for Toyota motor vehicles were placed through a trading company operating in Japan and having a subsidiary with offices in New York. Financing was provided by Japanese banks, having offices also in New York. J.S. App. 2a, 11a-12a. Neither the trading company nor the banks were authorized to do business in Puerto Rico, and they did not in fact do any business there (*ibid.*).

The commercial financing steps that facilitated appellant's importation of the vehicles were largely completed in New York. The shipping documents were sent to the New York offices of the Japanese banks, where drafts for the purchase price and attendant items were accepted by appellant's agent. The shipping documents were then forwarded to appellant, enabling it to take delivery of the vehicles upon their arrival in Puerto Rico. When the drafts came due, payment was made at the New York offices of the Japanese banks, by checks drawn against appellant's bank account in Puerto Rico. Those payments included interest on the advances made by the

Japanese banks during the financing period. J.S. App. 2a-3a, 11a-14a.

2. The Puerto Rico Income Tax Act of 1954 imposes a tax, at the flat rate of 29%, on the gross amount of "fixed or determinable annual or periodical * * * income," including interest, paid from a source within Puerto Rico to a "foreign corporation * * * not engaged in industry or business" in Puerto Rico. P.R. Laws Ann. tit. 13, § 3231(a)(1)(A) and (c) (1976 ed. & Cum. Supp. 1982).[1] The Act requires payors of such income items to withhold the tax at the source and remit it to Puerto Rican taxing authorities, making the withholding agents personally liable for any taxes not so withheld. *Id.* § 3144(c). These provisions are modeled closely on analogous sections of the Internal Revenue Code. See I.R.C. §§ 871, 881, 1441, 1442 and 1461.

Appellant failed to withhold the tax, as required by these provisions, on its interest payments to the Japanese banks during 1971-1973. The Secretary of the Treasury of Puerto Rico, appellee herein, accordingly asserted a deficiency in taxes against appellant for those years. J.S. App. 1a, 9a-10a.[2] Appellant sought review of the asserted deficiency in the Superior

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[1] A "foreign corporation" for purposes of Puerto Rico's withholding tax includes corporations incorporated elsewhere within the territorial jurisdiction of the United States, as well as those incorporated in other countries. See *International Harvester Co.* v. *Secretary of the Treasury*, No. R-82-511 (P.R. May 10, 1983) (reprinted at J.S. App. 30a-37a) (sustaining constitutionality of tax on Puerto Rico sourced interest paid to banks incorporated in mainland United States).

[2] Although the documents set forth in the appendix to the jurisdictional statement do not establish the amount of the deficiency asserted, appellant states that, including interest and penalties, it came to $1,428,300 (J.S. 1, 6-7).

Court of Puerto Rico, contending that the tax on interest paid to foreign corporations doing no business in Puerto Rico violated the Due Process Clause of the United States Constitution (J.S. App. 1a-2a, 9a-10a). The Superior Court upheld this contention, concluding that the Japanese banks had insufficient contacts or nexus with Puerto Rico to justify imposition of a tax upon the interest they received (*id.* at 19a-21a).

3. The Supreme Court of Puerto Rico, upon the Secretary's appeal, unanimously reversed (J.S. App. 1a-6a). It relied chiefly on its then-recent decision in *International Harvester Co.* v. *Secretary of the Treasury*, No. R-82-511 (May 10, 1983), which likewise involved a due process challenge to Puerto Rico's withholding tax on interest.[3] The court there had pointed out (J.S. App. 35a-36a) that the interest had its source in Puerto Rico, that the funds needed to pay the interest were generated in Puerto Rico, that the borrower required to withhold the tax was located and did business in Puerto Rico, and that the recipient's rights to the interest were protected by Puerto Rico's legal and economic system. Citing *International Harvester*, the court similarly concluded here that "there [was] a substantial nexus between the taxing state and the activity subject to taxation, and that the tax [was] related properly to the services or the benefits provided by the state." J.S. App. 4a.

The Supreme Court also adverted (J.S. App. 3a-5a) to the question whether Puerto Rico's tax had an impermissible impact upon interstate or foreign commerce. The court apparently did so on its own initia-

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[3] The *International Harvester* decision, which has not yet been officially reported in English, is reprinted at J.S. App. 30a-37a.

tive, noting that appellant's "objection as to its obligation to withhold taxes * * * [was] based on the due process clause" (*id.* at 3a), that appellant "did not present [its] allegations * * * under the premise that the tax in question should be scrutinized from a point of view of its impact on foreign commerce" (*ibid.* (footnote omitted)), and that allegations as to the practical effects of the tax on commerce "ha[d] not been presented in the case" (*id.* at 4a).

The court nevertheless opined that the tax would pass muster under Commerce Clause scrutiny, noting that source-based taxation of interest, dividends, and other non-business income "is well known in the international practice," that the distribution of the tax was not "unfair," and that the tax was not "one that discriminates against foreign banks" (J.S. App. 4a (emphasis omitted)). To the contrary, the court observed, inequality would truly arise if appellant's position were sustained, that is, if foreign banks were exempted from tax on interest earned in Puerto Rico, while all other banks were required to pay tax thereon (*ibid.*) With reference to the possibility of multiple taxation of interest earned on loans made in interstate or foreign commerce, the court observed that "the record is totally insufficient to make a judgment as to that, as well as showing the need of a uniform federal treatment." J.S. App. 3a, 5a (citing *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979)). Finally, the court noted (J.S. App. 5a) that the Income Tax Convention, Mar. 8, 1971, United States-Japan, 23 U.S.T. 969, did not affect the taxing powers of the states or of other sub-national government units.

DISCUSSION

1. a. We believe that, insofar as due process considerations are involved, there is no substantial reason to question the constitutionality of the Puerto Rican taxing statutes applied here. As the court below remarked (J.S. App. 4a), "[t]he tax contested herein is not new" and its use "is well known in the international practice." On the national level, the challenged statutes are substantially identical to—indeed, were directly modeled on—analogous provisions of the Internal Revenue Code. Sections 871 and 881 of the Code impose a tax at the flat rate of 30% on the gross amount of "fixed or determinable annual or periodical * * * income," including interest, received from sources within the United States by nonresident alien individuals and foreign corporations doing no business in this country.[4] Sections 1441 and 1442 require payors of such income items to withhold the tax at the source and remit it to the Treasury. Section 1461 makes such withholding agents personally liable for the taxes in question. Similar provisions have been in effect since the enactment of the Revenue Act of 1926, ch. 27, 44 Stat. 9 *et seq.*, and have been applied by this Court and others without any doubt as to their consistency with the Due Process Clause of the Fifth Amendment. *Helvering* v. *Stockholms Enskilda Bank*, 293 U.S. 84 (1934); *Com-*

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[4] Section 882 of the Code provides different treatment for foreign corporations engaged in a trade or business within the United States, providing that interest (and other items of "fixed or determinable annual or periodical * * * income") effectively connected with that trade or business shall be taxed on a net rather than a gross basis—*i.e.*, with offsetting business deductions allowed—and at graduated rates rather than at the flat rate of 30%. The Puerto Rico Income Tax Act of 1954 has similar provisions. P.R. Laws Ann. tit. 13, §§ 3013, 3015, 3231(b) (1976 ed. & Cum. Supp. 1982).

missioner v. *Wodehouse*, 337 U.S. 369 (1949). Moreover, this Court has upheld, in a number of contexts, the constitutionality of federal statutes imposing a duty to withhold and pay over taxes. See, *e.g.*, *Brushaber* v. *Union Pacific R.R.*, 240 U.S. 1, 21 (1916); *United States* v. *American Friends Service Committee*, 419 U.S. 7 (1974); *United States* v. *Sotelo*, 436 U.S. 268 (1978).

It is of course true that the jurisdictional limitations imposed upon the United States by the Due Process Clause of the Fifth Amendment may be less restrictive than the jurisdictional limitations imposed upon the Commonwealth of Puerto Rico by the Due Process Clause of the Fifth or Fourteenth Amendments,[5] or by the latter upon the several states.[6] In this case, however, all the considerations that support the unquestioned power of the federal government to tax United States source income received by nonresident aliens doing no business here, and to require that the disburser of funds withhold and pay over the tax, support parallel action by the Commonwealth of Puerto Rico. Simply put, if the source of the income, standing alone, provides sufficient "nexus" and "mini-

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[5] In *Torres* v. *Puerto Rico*, 442 U.S. 465 (1979), this Court stated that Puerto Rico is subject to "the Due Process Clause of either the Fifth or the Fourteenth Amendment" and to "the equal protection guarantee of either the Fifth or the Fourteenth Amendment." *Id.* at 469-470 (citing *Calero-Toledo* v. *Pearson Yacht Leasing Co.*, 416 U.S. 663, 668-669 n.5 (1974), and *Examining Board* v. *Flores de Otero*, 426 U.S. 572, 599-601 (1976)).

[6] Compare *United States* v. *Bennett*, 232 U.S. 299 (1914), and *Cook* v. *Tait*, 265 U.S. 47 (1924), with *Standard Oil Co.* v. *Peck*, 342 U.S. 382 (1952). And compare *Blackmer* v. *United States*, 284 U.S. 421 (1932), and *United States* v. *Bowman*, 260 U.S. 94 (1922), with *McDonald* v. *Mabee*, 243 U.S. 90 (1917).

mal contacts" to enable the United States to tax consistently with due process, the same must necessarily be true of the Commonwealth.

This Court long ago established the constitutional power of a state to tax nonresidents' income having its source within that state. *Shaffer* v. *Carter*, 252 U.S. 37 (1920); *Travis* v. *Yale & Towne Mfg. Co.*, 252 U.S. 60 (1920); *New York ex rel. Whitney* v. *Graves*, 299 U.S. 366 (1937); *International Harvester Co.* v. *Department of Taxation*, 322 U.S. 435, 441-442 (1944). See 1 J. Hellerstein, *State Taxation* ¶ 6.3, at 210-212 (1983). The Court also established long ago the power of a taxing state to employ collection at the source, that is, to require the in-state disburser to withhold and pay over taxes imposed on locally-sourced income. *Travis* v. *Yale & Towne Mfg. Co.*, *supra*; *Bell's Gap R.R.* v. *Pennsylvania*, 134 U.S. 232, 239 (1890). And the Court has denied certiorari in a case raising a due process challenge to predecessor (but substantially similar) Puerto Rican statutes which, like the statutes challenged here, required withholding of taxes on dividends and interest paid to foreign corporations doing no business in Puerto Rico. *Porto Rico Telephone Co.* v. *Descartes*, 255 F.2d 169 (1st Cir.), cert. denied, 358 U.S. 831 (1958).

b. In discussing cases involving sales and use taxes —taxes that involve quite different considerations— appellant (J.S. 10-16) fails to differentiate between jurisdiction to tax and jurisdiction to impose personal liability. In *State Board of Insurance* v. *Todd Shipyards Corp.*, 370 U.S. 451 (1962), Texas sought to impose an insurance premiums tax on "premiums paid out-of-state on out-of-state contracts" (370 U.S. at 453); the premiums did not have a source in Texas, and the "only connection between Texas and the insurance transactions [was] the fact that the

[insured] property [was] * * * physically located * * *" in the state (*id.* at 455). In those circumstances, this Court held that Texas lacked jurisdiction to tax.[7] In this case, by contrast, Puerto Rico seeks to tax income that undeniably has its source in Puerto Rico—interest payable on a loan that financed profitable business in Puerto Rico and that was paid from funds on deposit in Puerto Rico. As we have noted, this Court's decisions fully establish the jurisdiction of Puerto Rico to tax that income.

In *National Bellas Hess, Inc.* v. *Department of Revenue*, 386 U.S. 753 (1967), on the other hand, Illinois sought to require an out-of-state corporation, which had neither tangible property, sales outlets, nor representatives in Illinois, to collect taxes on the use in Illinois of goods sold by the corporation, and to impose personal liability on it for failure to collect. It was of course uncontested that Illinois had jurisdiction to tax the use of the goods by the in-state purchasers. But the Court held (386 U.S. at 757-758) that Illinois had no jurisdiction to impose personal liability for the tax on the out-of-state corporation.[8] In this case, however, Puerto Rico has not sought to impose personal liability upon the Japanese banks for the taxes on the interest they received. That liability

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[7] The Court's decision in *Todd Shipyards* was also influenced by the legislative history of the McCarran-Ferguson Act, 15 U.S.C. 1011 *et seq.* *See* 370 U.S. at 453-458.

[8] Although the taxpayer in *National Bellas Hess* based its claim for freedom from liability upon both the Due Process Clause of the Fourteenth Amendment and the Commerce Clause, and the Court stated that the two claims were "closely related" (386 U.S. at 756), the Court appears ultimately to have rested its decision on the Commerce Clause. See 386 U.S. at 760.

rests solely upon appellant, which was and is subject to the jurisdiction of Puerto Rico, and which failed to comply with a statutory withholding obligation that Puerto Rico had constitutional authority, under this Court's decisions, to impose upon its residents.

2. Although appellant invoked only the Due Process Clause in its Superior Court challenge to Puerto Rico's tax, the Supreme Court, on the Secretary's appeal, discussed the application of the Commerce Clause as well. It noted that appellant had failed to present allegations under the Commerce Clause (J.S. App. 3a-4a) and pointed out that the record would not have supported a Commerce Clause challenge had one been made (*id.* at 4a-5a). Appellant now maintains (J.S. 8 n.11) that the action of the Secretary and the decision of the Supreme Court are reviewable in this Court on Commerce Clause grounds as well as on due process grounds, and indeed focuses most of its arguments on the Commerce Clause (J.S. 16-28). We assume arguendo that appellant's Commerce Clause challenge is properly presented here, on the theory that the question was decided by, although not presented to, the court below. We agree with that court (J.S. App. 5a) that the record in this case furnishes no support for appellant's contentions.

To begin with, appellant has failed to develop a factual record sufficient to substantiate its allegations that Puerto Rico's tax causes "double taxation" (J.S. 22), "triple taxation" (*id.* at 21), or misapportionment of the tax burden (*id.* at 21-22). In *Standard Pressed Steel Co.* v. *Washington Revenue Department*, 419 U.S. 560 (1975), the source state imposed a tax on the gross amount paid to a supplier in another state, and the tax was challenged under the Commerce Clause. This Court upheld the tax, noting that the "burden is on the taxpayer" to demonstrate

multiple taxation and concluding that "[no] effort [was] made to establish it" there. 419 U.S. at 563 (citing *General Motors Corp.* v. *Washington*, 377 U.S. 436, 447 (1964)). Accord, *Moorman Mfg. Co.* v. *Bair*, 437 U.S. 267, 276-281 (1978). The Supreme Court of Puerto Rico properly concluded (J.S. App. 4a) that appellant had likewise made no effort to establish the fact of multiple taxation here.

For somewhat similar reasons, appellant's arguments (J.S. 22-28) based upon this Court's decision in *Japan Line, Ltd.* v. *County of Los Angeles*, 441 U.S. 434 (1979), are unpersuasive. That case involved an ad valorem property tax on tangible personal property, *i.e.*, shipping containers that were "subject to property tax in Japan and, in fact, [were] taxed there" (441 U.S. at 436). As this Court noted in *Container Corp.* v. *Franchise Tax Board*, No. 81-523 (June 27, 1983), slip op. 26, there are significant differences between a tax on income and an ad valorem tax on tangible property. The *Container Corp.* decision likewise demonstrates that there is no substance to appellant's argument, predicated on the Income Tax Convention, Mar. 8, 1971, United States-Japan, 23 U.S.T. 969 (J.S. 23-26), that Puerto Rico's tax "impairs federal uniformity" in violation of *Japan Line*. The Court in *Container Corp.* pointed out (slip op. 35 (footnote omitted)) that "none of the tax treaties into which the United States has entered covers the taxing activities of sub-national governmental units such as States." And even if *Japan Line* were otherwise applicable, the taxpayer there demonstrated the fact of multiple taxation (441 U.S. at 452 & n.17), something appellant has made no attempt to do.

Appellant's contention that Puerto Rico's tax discriminates against interstate and foreign commerce, and in favor of local commerce (J.S. 18-20), is

equally without merit. Appellant argues that Puerto Rico taxes the interest income of banks doing business in Puerto Rico at a lower rate than that of banks not engaged in business there (*id.* at 18). If this charge were demonstrated to be correct, the argument would carry substantial weight. *Boston Stock Exchange* v. *State Tax Commission*, 429 U.S. 318 (1977); *Westinghouse Electric Corp.* v. *Tully*, No. 81-2394 (Apr. 24, 1984). Appellant, however, has provided no proof to support its charge.

As appellant observes (J.S. 18), Puerto Rico imposes a withholding tax at a flat rate of 29% on gross Puerto Rico source interest income of foreign corporations, whereas it imposes a corporate tax at a normal rate of 22% on the total net income of local corporations. Yet appellant has made no effort to show that this difference in taxing regimes creates any systematic discrimination (or, indeed, any discrimination at all) against foreign taxpayers. As far as the difference in rates is concerned, it is true that local enterprises pay tax at a normal rate of 22%. But local enterprises are also subjected to a surtax at the rate of 9% on the first $75,000 of surtax net income, plus 19% on the amount of surtax net income over $75,000 (P.R. Laws Ann. tit. 13, §§ 3015, 3026(b) (1976 ed. & Cum. Supp. 1982), reprinted at J.S. App. 29a).[9] "[A] proper analysis must take 'the whole scheme of taxation into account.'" *Halliburton Oil Well Cementing Co.* v. *Reily*, 373 U.S. 64, 69 (1963); *Caskey Baking Co.* v. *Virginia*, 313 U.S. 117, 119-120 (1941). Cf. *Maryland* v. *Louisiana*, 451 U.S. 725, 756 (1981). Moreover, as far as the

[9] Section 3015(a) defines "[s]urtax [n]et [i]ncome" as "normal-tax net income minus the credits provided in section 3026(b) of this title." Section 3026(b) provides, with exceptions not here relevant, that "[f]or the purposes of the surtax a credit of $25,000 shall be allowed."

difference between taxes on gross and on net income is concerned, appellant has not shown that banks making advances to it incurred related expenses that would properly be deductible against their Puerto Rico source interest income, or, if so, what the amounts of those deductions would be. In short, appellant has demonstrated no discrimination against foreign lenders; it is entirely possible that local lenders are subject to higher rates of tax.

3. Appellant's foreign commerce arguments, finally, ring particularly hollow when one considers the practical realities of the case. It is noteworthy that foreign corporations have not brought or supported challenges to the constitutionality of Puerto Rico's source-based tax, in contrast to the situation in *Japan Line* and *Container Corp.* This probably reflects, in part, the fact that Puerto Rico's tax would be creditable against foreign corporations' domestic income tax liabilities.[10] It presumably also reflects the fact that source-based taxation of income from intangibles is the accepted international norm (see J.S. App. 4a). And specifically, it presumably also reflects that fact that Puerto Rico's tax generally does not subject foreign corporations to a greater aggregate tax liability than they would incur if they lent money to a borrower elsewhere within the territorial jurisdiction of the United States.

If a foreign corporation that does business in any of the states of the United States lends money there, its interest income will generally be subject to federal income tax, at marginal rates as high as 46%, and probably to state income taxes as well. If a foreign

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[10] Appellant appears to acknowledge that such a credit would be available under Japanese corporate tax law to the Japanese banks that lent money to it here. See J.S. 27.

corporation that does *no* business in any of the states of the United States lends money there, its interest income will generally be subject to a source-based federal income tax, at a flat rate of 30%, subject to possible reduction by treaty. I.R.C. §§ 871, 881, 894. If a foreign corporation that does no business in Puerto Rico lends money *there*, its interest income will be immune from federal tax, and will be subject to a source-based Puerto Rico income tax at a flat rate of 29%. Although the considerations that affect foreign corporations' choices about where to lend are surely manifold, they will generally view it is as immaterial whether they pay a 29% tax to Puerto Rico or a 30% tax to the federal government—or (as here) a treaty-reduced tax to the federal government,[11] at least where the tax is creditable against their domestic tax liabilities (see page 13 note 10, *supra*).

The parties with the clearest stake in the outcome, of course, are not foreign lenders, but Puerto Rican residents like appellant. If they are successful in invalidating Puerto Rico's withholding tax, they will be able to borrow money abroad free of tax by any United States jurisdiction, in effect conferring a species of tax-haven status on Puerto Rico and a species of tax-exempt status on themselves. While this result would concededly permit Puerto Rican residents to borrow abroad at lower interest rates, it is not a re-

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[11] As appellant notes (J.S. 23-26), the federal source-based tax applicable to most Japanese banks has been reduced by treaty to 10%. As we have discussed earlier (page 11, *supra*), however, the treaty does not apply to taxation by Puerto Rico, and this Court's decision in *Container Corp.* forecloses appellant's argument that the difference between the treaty rate and Puerto Rico's tax rate "impairs federal uniformity" within the meaning of *Japan Line*.

sult constitutionally required by the foreign Commerce Clause.

Nor is it the result intended by Congress in drafting the Internal Revenue Code. Congress obviously has the power to tax foreign income sourced in Puerto Rico, just as it taxes foreign income sourced in the fifty states. But Congress has forborne to do so, in effect ceding priority of taxing jurisdiction to the Commonwealth. Appellant is attempting to seize for itself the benefits of that forbearance, benefits that Congress intended should instead inure to the Treasury of Puerto Rico.

CONCLUSION

The appeal should be dismissed for want of a substantial federal question.

Respectfully submitted.

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